Rhone-poulenc rorer, inc case-study

Economics, Financial Markets

Almost every aspect of the complexity of the merger can be explained through Rhone-Poulenc's financial constraints. RP's motives to acquire Rorer were to create crucial capital for its own strategic entry into pharmaceuticals. RP could not buy Rorer either in cash or shares due to the following factors: First, RP had limited ability to pay with borrowed cash. The company was more levered than other firms in the industry. Rhone-Poulenc didn't want to borrow all the cash because it would have affected in a negative way to its balance sheet despite the fact that it borrowed for the cash portion of the deal.

Second, Rhone-Poulenc couldn't pay with internally generated cash because, during the announcement time, RP was a net cash user in connection with its great capital spending requirements and the recession felling on chemicals markets. Third, RP could not pay with debt securities. It is logical that if the company was too highly levered to borrow and pay in cash, it was too highly levered to swap debt securities for shares. Fourth, Rhone-Poulenc could not pay with RP common shares or with cash raised from selling equity.

A deal based on shares would not have been approved by old shareholders because the deal would have diluted the value of individual shares and it would have not been profitable because the RP's management believed the company's share price was undervalued. Rhone-Poulenc could not offer standard common stock because it didn't have any, so it had to offer only nonvoting certificate of investment as a state-owned company as it was.

2. In case of Rhone-Poulenc Rorer, Inc, the shareholders of Rorer received a CVR that enabled them to receive additional gains from the possible shortfall of the future stock price and to persuade the Rorer shareholders to continue

as the minority equity investors in the Rhone-Poulenc Rorer, Inc. Rhone-Poulenc could not pay with RP common shares or with cash raised from selling equity. A deal based on shares would not have been approved by old shareholders because the deal would have diluted the value of individual shares and it would have not been profitable because the RP's management believed the company's share price was undervalued.

Rhone-Poulenc could not offer standard common stock because it didn't have any, so it had to offer only nonvoting certificate of investment as a state-owned company as it was. 3. The assumption is that RP is not going to use its right to extend the maturity of the CVRs, and they are thus expiring in July 31, 1993. We have used the binomial tree to value the CVRs as a put option. The value of a CVR is thus $5. 54, and the aggregate value is $231. 64 million. Secondly, we have calculated the value of the CVRs in August 1991, assuming this is the date when the case was written.

In addition, I am still assuming that RP isn't going to extend the maturity. I've used almost the same method as in the previous calculation and the value of a CVR is $2. 78, and the aggregate value is thus $116. 34 million. 4. The investor can see the offering quite attractive. This is due to the fact that they now have limited their downside risks with the put option. This means the minority have an effective hedge against the possibility offailureof the upcoming merger. Rhone-Poulenc managed to entice all the shareholders of the acquired Rorer with its somewhat complicated three-stage transaction.

The initial tender offer and giving the rights to control RP's HPB was attractive enough for Rorer to accept the deal. The Contingent Value Rights gave the minority shareholders the rights they thought were valuable

enough to close the deal. Rorer believed that the whole package was indeed worth of $36. 50 per share. Rorer benefited from the announcement of this deal and gained about $632 million in new value. However, RP's non-voting common shares decreased 4. 4 percent, or $175 million, in value. The fact is, all in all, that RP has a huge liability due to the CVRs.

In the worst case scenario, the share price falls below $26. 00 and the liability would thus be ($49. 13 - $26. 00) * 41. 8 million = $966. 83 million, which is the maximum amount of RP's liability. The maximum liability was perfectly hedged, providing RP a delta neutral position. Extra. RP would prefer the share price to stay higher than $49. 13 until 1993, and $53. 06 until 1994. This is because in these cases RP would not be obliged to pay CVR-holders the cash payments. Thus if the share price would be higher than $49. 13 in the expiration date of the CVRs, RP would not extend the maturity of the Contingent Value Rights

Introduction A merger between Rorer Group, Inc and the Human Pharmaceutical Business (HPB) of Rhone-Poulenc (RP) S. A. generated a major multinational pharmaceutical company, Rhone-Poulenc Rorer (RPR) on July 31, 1990. The expectations concerning takeover of Rorer had aroused in the late 1980s when the considerably low cash balance and rising level of debt seemed to slow down its strategy of growth by acquisitions. The rumors had reassurance in 1989 when Rorer made a bid to take over the pharmaceutical business of A. H. Robins and lost the opportunity.

Just a short time after this, the $3. 2 billion merger of Rorer and RP was announced. A year later the company had shown rapid post-merger integration and initial synergy gains. RP had practically no position in the

United States and Japan, but on the other hand it had a strong market share in some European Community markets. Thanks to Rorer's U. S. connections, the new company ranked among the top three in Europe and had improved its position in the United States. Rorer's Robert Cawthorn continued as RPR's CEO and almost all the new senior executives came from Rhone-Poulenc.

The markets expected RP to slowly take over the company because it owned 68% of RPR's shares. The French government owned 100% of Rhone-Poulenc's voting common stock. RP was the seventh largest chemical manufacturer in the world and it gave the minority shareholders a contingent value right (CVR) that promised to pay them on July 31, 1993, any shortfall between $49. 13 and the then prevailing stock price. Rorer Goup, Inc's main factor in its growth strategy had been a program of acquisitions, because sales growth in the company's existing product lines was characterized as mature.

As usual, there were several skeptics associated to this merger. They were worried about the cultural integration and independence. The skeptics pointed out the company is French, yet the management team is mainly American, they have a American-style mission statement (" Our Mission is to become the BEST pharmaceutical company in the world by dedicating our resources, our talents, and our energies to help improve humanhealthand the quality of life of people throughout the world") and the lack of interest of the American executives to learn French. The market outlook for the industry wasn't favorable for the company.

The cost of new-product development in the industry was rising and yet the number of new drug applications worldwide had fallen. It was also predicted

that the governments would get tougher on the cost of drugs in an effort to slow down rapidly rising health costs. Other risks to consider were patent expiration and competition from low-priced generic drug manufacturers and decreasing product life cycles. In turn, the world population was aging, analysts noted that computers and biotechnology were aiding new-product development and different analysts recommended to buy the RPR's stock on the long term. . The $3. 2 billion merger was consummated in a three-stage transaction, by which Rhone-Poulenc obtained 68% of Rorer's common stock (91. 6 shares), which was enough to permit Rhone-Poulenc to consolidate Rorer's results for financial reporting. First, Rhone-Poulenc would tender for 50. 1% (43. 2 million shares) of Rorer's common stock for $36. 50 cash per share. Rhone-Poulenc increased its debt/capital ratio to 45% by borrowing the funds tofinancethe tender offer. The debt/capital ratio was considerably high compared to its competitors ratio of 20-30%.

Second, Rorer assumed $265 million of RP debt (guaranteed by RP), made a $20 million cash payment to RP, and issued 48. 4 million new common shares to RP in exchange for RP's HPB division. Analysts believed that Rorer's bylaws would require at least 85% of all shares be voted in favor of the issuance of new shares and, more generally, of this entire transaction. Third, Rhone-Poulenc issued the 41. 8 million CVRs to the remaining minority shareholders in Rorer. A CVR entitled the holder to the right, at the end of three years (July 31, 1993) or four years, at RP's option, to a cash payment of US$49. 13 (or $53. 6 if the payment were made at the end of four years) reduced by the higher of the value of the RPR share at that date or $26. Thus, if the value of the RPR share exceeded $49. 13 (or $53. 06), there

would be no payment. The maximum amount of RP’s liability on December 31, 1990, was 5 165 million French francs at the date of the issuance of the rights. The maximum amount of RP’s liability at the date of issuance was hedged. Any changes in the value of the CVRs resulting from fluctuations in exchange rates, as well as the amortization of the cost of the hedge, were recorded directly into the consolidated equity of RP.

The CVRs were quoted on the American Stock Exchange and traded independently of the shares of EPE, which were listed on the New York Stock Exchange. Rorer and RP jointly released its own estimate of the package value of CRV and minority share in RPR to be worth $36. 50 and thus equal to the price at which RP was offering for shares of RPR. Rorer’s investors responded positively to the merger arrangements. Rorer shares increased by 28% net of the changes in the Standard & Poor’s 500 index over the week during the week of the announcement. This gain equaled about $632 million in new value.

Simultaneously, RP’s nonvoting common shares lost 4. 4% net of market during the announcement week, or about $175 million. Almost every aspect of the complexity of the merger can be explained through Rhone-Poulenc’s financial constraints. RP’s motives to acquire Rorer were to create crucial capital for its own strategic entry into pharmaceuticals. RP could not buy Rorer either in cash or shares due to the following factors: First, RP had limited ability to pay with borrowed cash. The company was more levered than other firms in the industry.

Rhone-Poulenc didn’t want to borrow all the cash because it would have affected in a negative way to its balance sheet despite the fact that it

borrowed for the cash portion of the deal. Second, Rhone-Poulenc couldn't pay with internally generated cash because, during the announcement time, RP was a net cash user in connection with its great capital spending requirements and the recession felling on chemicals markets. Third, RP could not pay with debt securities. It is logical that if the company was too highly levered to borrow and pay in cash, it was too highly levered to swap debt securities for shares.

Fourth, Rhone-Poulenc could not pay with RP common shares or with cash raised from selling equity. A deal based on shares would not have been approved by old shareholders because the deal would have diluted the value of individual shares and it would have not been profitable because the RP's management believed the company's share price was undervalued. Rhone-Poulenc could not offer standard common stock because it didn't have any, so it had to offer only nonvoting certificate of investment as a state-owned company as it was.

The form of the deal solved Rhone-Poulenc's financial problems and it made possible for the firm to generate capital for its human pharmaceutical business and raise equity via obtaining Rorer's shareholders to remain as minority equity investors in the Rhone-Poulenc Rorer, Inc. It would be natural to RP to want to issue equity for part of the deal but for the reasons mentioned above, it could not do so. 2. Contingent Value Right (CVR) is a type of right given to shareholders of an acquired company that ensures them to receive additional benefit if a specified event occurs.

CVRs are handy tools that may help deal makers surmount challenging deal design problems. The use of CVRs is relatively rare, but they are useful when

the seller company is seeking protection for the remaining minority shareholders who might be vulnerable to unfair treatment by the acquirer, the seller's board may be concerned the buyer's share price may not retain its value if the deal's projected synergies are not achieved, the integration is not smooth, or the buyer's legacy business does not perform as expected.

In case of Rhone-Poulenc Rorer, Inc, the shareholders of Rorer received a CVR that enabled them to receive additional gains from the possible shortfall of the future stock price and to persuade the Rorer shareholders to continue as the minority equity investors in the Rhone-Poulenc Rorer, Inc. Rhone-Poulenc could not pay with RP common shares or with cash raised from selling equity. A deal based on shares would not have been approved by old shareholders because the deal would have diluted the value of individual shares and it would have not been profitable because the RP's management believed the company's share price was undervalued.

Rhone-Poulenc could not offer standard common stock because it didn't have any, so it had to offer only nonvoting certificate of investment as a state-owned company as it was. Shareholders selling their Rorer shares to Rhone-Poulenc were paid in three forms. They received totaling $1. 7 billion, shares in Rhone-Poulenc Rorer and CVRs. If, at the end of three years, the RPR share price did not exceed $98, Rhone-Poulenc had to pay CVR holders the difference between the share price and $98, to an upper limit of $46 per CVR.

If the RPR share price was below $52 on August 1, 1993, RP would have to pay the CVR holders $1 billion (in FRF over 5 billion). By the end of 1991, the price of the CVR had fallen by 4/5 of its value. Its close at under $1 reflected

the good performance of the group. RP took the opportunity to buy all the CVRs it had been offered. During the first year after issue, the group gathered in 20. 7 million CVRs, half the total number issued. 3. The assumption is that RP is not going to use its right to extend the maturity of the CVRs, and they are thus expiring in July 31, 1993.

We have used the binomial tree (Exhibit A) to value the CVRs as a put option. The value of a CVR is thus $5. 54, and the aggregate value is $231. 64 million. I have assumed risk-free rate of 8. 20 percent, which is the yield of a 3-year U. S. Treasury note. The standard deviation was given, 18 percent, and we have used it to calculate u and d enabling me to calculate p also. We have used $36. 50 as S(0). Secondly, we have calculated the value of the CVRs in August 1991, assuming this is the date when the case was written. In addition, we are still assuming that RP isn't going to extend the maturity.

We have used almost the same method as above (Exhibit B) and the value of a CVR is $2. 78, and the aggregate value is thus $116. 34 million. Only difference is that we used 0. 172 (= 0, 18*(SQRT(11/12)) as standard deviation, since there is not full year until maturity. We have used 8. 09 percent as the risk-free rate, which is the yield of a 2-year Treasury note. The share price in August 1, 1991 was $45. 75, which is the value of S(0) in my calculations. As we can see, the value of the CVR is considerably smaller in the latter case, due to the decrease in the time value of the put option. 4. The investor can see the offering quite attractive.

This is due to the fact that they now have limited their downside risks with the put option. This means the minority have an effective hedge against the possibility of failure of the upcoming merger. The investors are receiving a

cash payment of $49. 13 (or $53. 06 in the case of RP extending the maturity) minus the then prevailing share price or $26. 00. In one hand their shares can gain possible extra value and in the other they have a limit for the possible losses. Rhone-Poulenc managed to entice all the shareholders of the acquired Rorer with its somewhat complicated three-stage transaction.

The initial tender offer and giving the rights to control RP's HPB was attractive enough for Rorer to accept the deal. The Contingent Value Rights gave the minority shareholders the rights they thought were valuable enough to close the deal. Rorer believed that the whole package was indeed worth of $36. 50 per share. Rorer benefited from the announcement of this deal and gained about $632 million in new value. However, RP's non-voting common shares decreased 4. 4 percent, or $175 million, in value. The fact is, all in all, that RP has a huge liability due to the CVRs.

In the worst case scenario, the share price falls below $26. 00 and the liability would thus be ($49. 13 - $26. 00) * 41. 8 million = $966. 83 million, which is the maximum amount of RP's liability. The maximum liability was perfectly hedged, providing RP a delta neutral position. This is possible through adjusting the ratio of CVRs and RPR equity, in the case of price changes of these CVRs. Extra question RP would prefer the share price to stay higher than $49. 13 until 1993, and $53. 06 until 1994. This is because in these cases RP would not be obliged to pay CVR-holders the cash payments.

Thus if the share price would be higher than $49. 13 in the expiration date of the CVRs, RP would not extend the maturity of the Contingent Value Rights. I have calculated the value of the CVRs in case the maturity is extended until

1994. The calculations are in the Exhibit C, and the value of a CVR is thus $5. 57 and the aggregate value is $232. 89 million. In 1993, if the share price is S(uud) = $43. 70, the CVRs' maturity might be extended, because now there would be a possibility of the share price to increase to $52. 32 and the extension would have been preferable.